Wired Solutions

FOR A PRE-WIRED WORLD

AWARE, INC. | ANNUAL REPORT 1997

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B R E A K I N G   T H E   S P E E D   B A R R I E R   I N

Internet Access

PC processing power continues to double every 18 months – representing a rapid rate of technological change that has created a Golden Age of productivity improvements since computers first arrived on the scene. But try to access that data by jumping on the information highway or surfing the Web using ordinary voiceband modems, and you're right back in the Dark Ages – stuck in a frustrating gridlock where data transmissions slow to a crawl.

Impatient with the pace of today's modems (not to mention the unfulfilled promise of ISDN technology), the millions of computer users around the world are clamoring for a quantum-leap improvement in high-speed data access technology. The need for an affordable, easy-to-install solution is immediate. The demand will be explosive. And the market size will be staggering – estimated at a multi-billion dollar business opportunity.

Aware was an early pioneer in the development of ultra high-speed transmission technology that catapults data communications out of the Dark Ages and into the future. This breakthrough technology leapfrogs conventional approaches and sets a new high-speed standard for improving even the most bandwidth-hungry applications and accessing media-rich Internet sites. This year's annual report spotlights our success in transforming this technology into product solutions and in forging the strategic partnerships needed to capitalize on the enormous market opportunity that lies ahead.

Dear Shareholder

Two noteworthy events propelled Aware toward industry prominence in 1997, our first full year as a public company — events so significant that they captured the attention of the national news media by promising to accelerate the widespread deployment of ADSL technology.

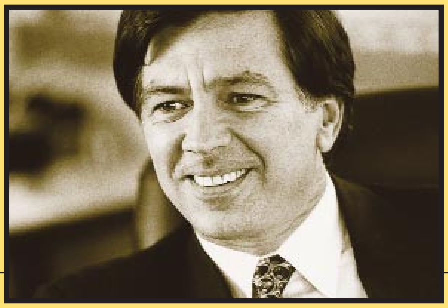
The first event is nothing short of a technological breakthrough. In 1997, we cleared a major hurdle blocking the economical mass-market deployment of ADSL by developing "splitterless" DMT technology. This new technology will make ADSL as easy to install at customer premises as today's ordinary PC modems. In addition to eliminating the need for on-site installation by trained technicians, splitterless DMT supports speeds of up to 1.5 megabits per second – 30 times faster than the fastest conventional voiceband modems. Even more important, its upward compatibility positions it as an ideal stepping stone to full-rate ADSL technology. While others believed that splitterless DMT could not be achieved, we have successfully pioneered its development, proved its viability and filed patent applications for our intellectual property rights.

The advent of our new splitterless DMT technology led to the second major event of the year: the decision by Compaq, Microsoft and Intel to embrace splitterless DMT for their future generation computer products. In effect, this is a clear sign that the PC industry is stepping forward to offload the responsibility of deploying ADSL technology at the customer premise from the telephone companies — eliminating the time and cost of having to send a technician to each customer site. With the involvement of the PC industry and the on-site installation requirement replaced with a plug-and-play modem, we expect that the industry is now on the threshold of meaningful ADSL deployment.

The industry momentum created by our splitterless DMT development efforts contributed to the formation of the Universal ADSL Working Group (UAWG) in 1997. Representing a virtual powerhouse of major computer chip manufacturers, PC system vendors, telecommunications equipment suppliers and all the leading service providers, the UAWG is leading an industry-wide charge to establish splitterless DMT as a universal standard — further enhancing our competitive position by promoting the widespread acceptance of splitterless DMT.

Collectively, these events have transformed the mass deployment of ADSL technology from an "if" to a very foreseeable "when." Together with our strategic partners, we are now closer than ever to providing a practical and affordable ADSL solution for the 700 million existing phone lines worldwide, representing a multi-billion dollar market for our industry.

To prepare for this market opportunity, we continued to build our ADSL product base — successfully moving from the prototype stage to the initial production of our first commercial products. These include the x200 access router, the world's fastest modem using existing copper lines; the AW-910 module, designed for speedy ADSL deployment by original equipment manufacturers (OEMs), and the ADS-910, a test and development system to accelerate OEMs' time-to-market. We also co-developed Analog Devices' first production chipset, the lowest-cost ADSL solution on the market. Moreover, by outsourcing the manufacturing of our products, we aim to strengthen our bottom line by achieving higher gross margin performance and lower cost of goods when volume production begins.



JAMES C. BENDER
President & Chief Executive Officer

CHARLES K. STEWART
Chairman of the Board

Aware also redefined its strategic partnership with Analog Devices in early 1998. Analog had been our exclusive partner on ADSL chipset development since 1993. Our new relationship allows us to more widely proliferate our technology, promote open systems and drive interoperability. The new agreement enhances Analog Devices' competitive position and enables it to more effectively serve our mutual customers. We look forward to continuing to work closely together with Analog Devices on chipset enhancements through multiple generations of software and semiconductor improvements.

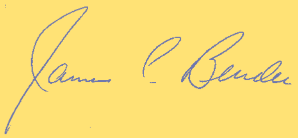
Throughout 1997, Aware continued to pursue new strategic partnerships with leading telecommunications and data communication equipment manufacturers that are critical to widespread ADSL deployment. Specifically, we formed new partnerships with Cisco Systems, the world's leading router company, and with 3Com/US Robotics, the world's largest voiceband modem company. In addition, we signed an agreement with Lucent Technologies, a global telecommunications equipment manufacturer, to develop a modem chipset that contains our new splitterless DMT technology.

Last year we also moved our headquarters into a newly renovated 72,000 square-foot building which we purchased in Bedford, Massachusetts. In addition to consolidating all of our operations, this new facility significantly increases our space capacity — enabling us to add the critical resources we need to capitalize on the market opportunities ahead.

In terms of our financial performance, 1997 revenue increased to $6.2 million, up 17% over 1996 revenue of $5.3 million. Net loss for 1997 was $4.4 million or minus $0.23 per share on a diluted basis, compared to net income of $259,000 or $0.01 per share on a diluted basis in 1996. This loss was principally due to our decision to aggressively ramp up our activities in two strategic areas during the year. First, we more than doubled our research and development investment over 1996 in order to position the company with new products designed to capitalize on pent-up consumer demand. And second, we nearly tripled our sales and marketing spending over 1996 to gear up for the emerging market. Looking ahead, we expect our products to contribute an increasingly higher percentage of total company revenue over the next few years.

In closing, we express our deepest appreciation to our employees for their outstanding contributions of the last year. Their dedication and expertise, coupled with the loyal support of our partners, customers and shareholders, are the driving forces behind our ability to help move ADSL from promise to realization in the not-too-distant future.

Sincerely,



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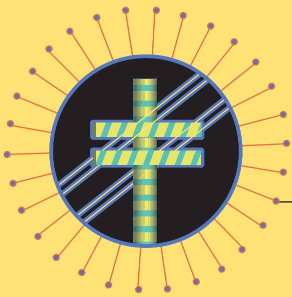


THE TECHNOLOGY SOLUTION

A Copper Renaissance

To create the bandwidth needed to deliver the Internet's rich, multimedia capabilities to the mass market, telephone companies have been faced with the prospect of scrapping the existing $100 billion network and rewiring the entire world with higher bandwidth fiber optic cable. With 700 million lines worldwide, the sheer size of this existing network makes the rewiring job both time- and cost-prohibitive — particularly the last mile between the phone company and each subscriber, which accounts for about 80% of the cost of the network.

Enter ADSL (Asymmetric Digital Subscriber Line), a high-speed "last mile" technology that provides a practical and proven alternative to rewiring the world. Simply stated, ADSL dramatically expands the bandwidth of existing telephone networks. As a result, it enables sophisticated Internet broadband services to be delivered over the 700 million copper access lines in the world today — in effect, creating a "copper renaissance."

Aware is a world leader in ultra high-speed ADSL last-mile technology. Using existing copper phone lines, our ADSL technology transmits data at speeds of over 9 megabits per second — 300 times faster than 28.8 modems, 70 times faster than ISDN, and 6 times faster than T1 lines. What's more, its dedicated bandwidth ensures consistently high performance, unlike the shared bandwidth of cable modems which can diminish transfer rates and create security breaches.

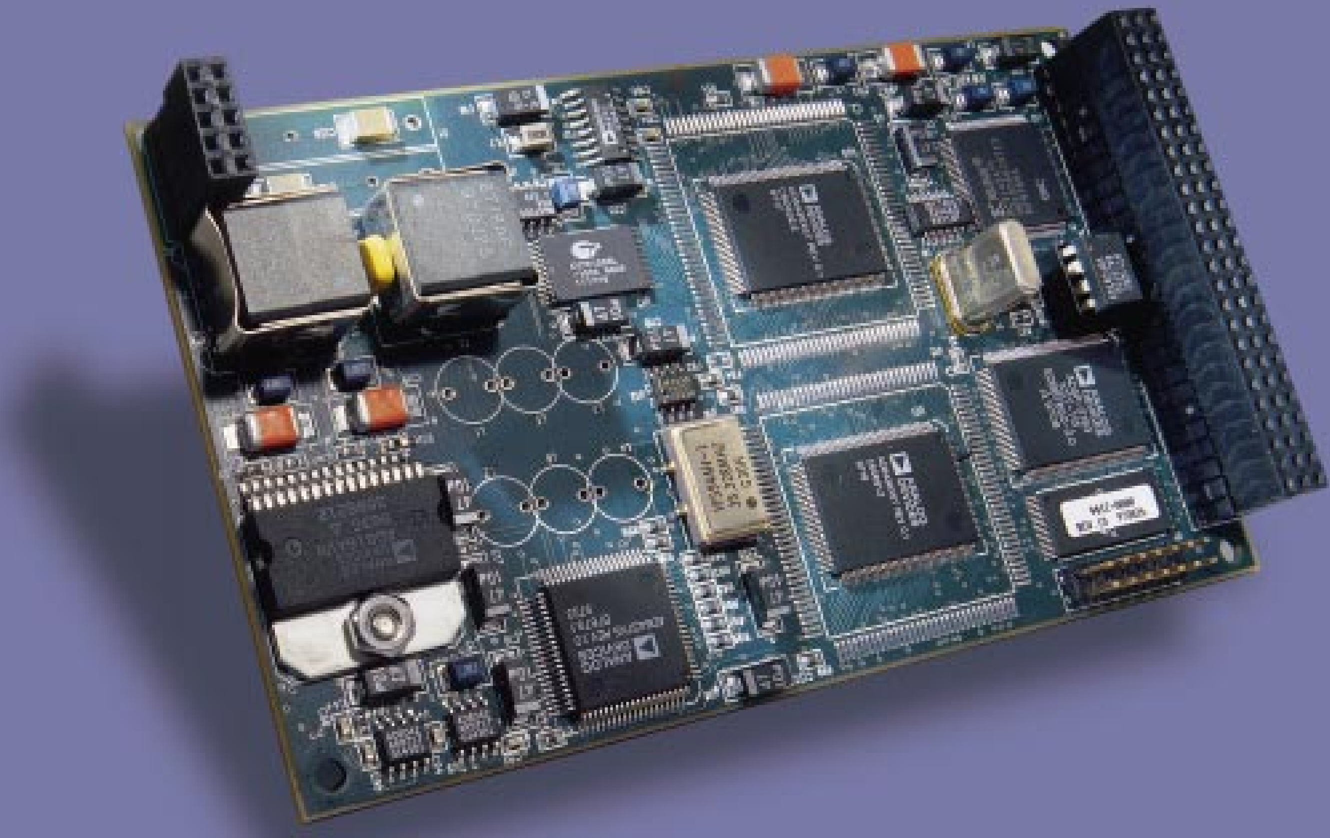
Lightning-fast speed is only one of ADSL's competitive advantages. It also eliminates the need for a second phone line by supporting simultaneous voice and data transmission… maximizes performance by automatically adapting transmission speed to compensate for local line conditions… and will ensure complete interoperability by supporting the widely accepted Discrete Multitone (DMT) standard.

In 1997, Aware made history as the first company to develop "splitterless" DMT technology. This breakthrough will make customer premises equipment as easy to install as today's voiceband PC modems in most cases. Not only will splitterless DMT modems simply plug into a regular phone jack, they will perform at up to 1.5 Mbps — 30 times faster than today's fastest analog modems. In addition to maintaining full interoperability with standards-based ADSL central office equipment, splitterless DMT will also expand the local loop to beyond 22,000 feet — covering virtually all American homes.

Based on the initial development and demonstrated viability of Aware's splitterless DMT technology, some leading computer manufacturers plan to build it into their name-brand PCs in the near future. By providing an upward migration path to full-rate ADSL, splitterless DMT is expected to break open the marketplace and accelerate the wide-scale deployment of full-rate ADSL — predicted to be a billion dollar market by the year 2000.

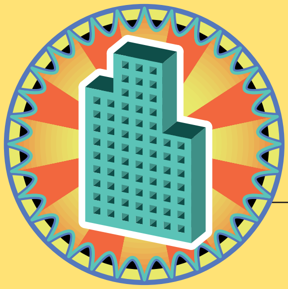
x200 ADSL Access Router: The new "splitterless" x200 Lite version of this high-speed access solution will install as easily as today's PC modem.

x200 ADSL Access Router



AW–910

ADSL Transceiver Module



THE COMPANY SOLUTION

Aware, Inc.

Aware is a technology innovator — pioneering the development of breakthrough, market-driven solutions that meet today's immediate need for ubiquitous high-speed Internet access and broadband communications services.

Being a technology leader demands a commitment to being first. That's why Aware is an organization built for speed. Our "first-to-market" track record — unprecedented in the DSL industry — speaks for itself:

First DMT ADSL chipset. Co-developed with Analog Devices, the AD20msp910 chipset for Original Equipment Manufacturers (OEMs) enables the development of ADSL equipment for high-speed Internet access and multimedia services. Today, it is the lowest-cost, highest-performance DMT ADSL chipset on the market.

First DMT ADSL transceiver module (AW-910). This plug-and-play module is a fast way for OEMs to integrate Aware's ADSL technology into telecommunications and networking equipment. It contains all the digital and analog IC components (including the AD20msp910 chipset) which are required to implement both the central office and customer premise ends of an ADSL connection. The AW-910 quickly led to yet another innovation — Aware's ADS-910 Development System, which provides OEMs with a single, compact platform for evaluating both ends of an ADSL link.

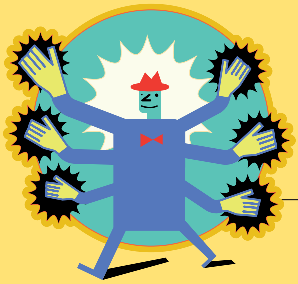
First commercially available DMT-based access router (x200). Designed to make broadband applications such as high-speed Internet access, video conferencing, telecommuting and electronic commerce a reality, the ultra-fast x200 transmits data and video over ordinary copper phone lines more than 200 times faster than a standard 28.8 Kbps modem — while simultaneously maintaining traditional telephone voice service. The x200's routing capabilities also make it well-suited for remote and branch office routing.

First DMT ADSL rate-adaptive technology. By automatically adapting to a variety of different telephone line conditions, our DMT ADSL rate-adaptive technology contained within our modems makes those connections more reliable and delivers the maximum performance a line can handle.

First to demonstrate and deliver "splitterless" DMT technology. This historic milestone removes one of the last remaining obstacles to the mass deployment of ADSL — the time and cost of installing a voice-data splitter at the customer premise. It enables the development of simple plug-and-play, high-speed modems which eliminate the need for special installation services.

Guided by the proven expertise of our management team, our well-capitalized organization brings 12 years of experience to bear on extending our technology leadership. Today, engineering personnel account for more than two-thirds of our work force — representing a first-rate research and development team that continues to build our technology base and transform our innovations into successful product solutions.

AW-910 ADSL Transceiver Module: All-in-one, plug-and-play solution for rapidly deploying ADSL technology.



THE ADSL ROLL-OUT SOLUTION

Partnering with Market Leaders

In order to gain market share and pave the way for the full-scale deployment of its ADSL innovations, Aware is forming strategic alliances with the major computer chip manufacturers and system vendors serving today's leading telecommunications service providers.

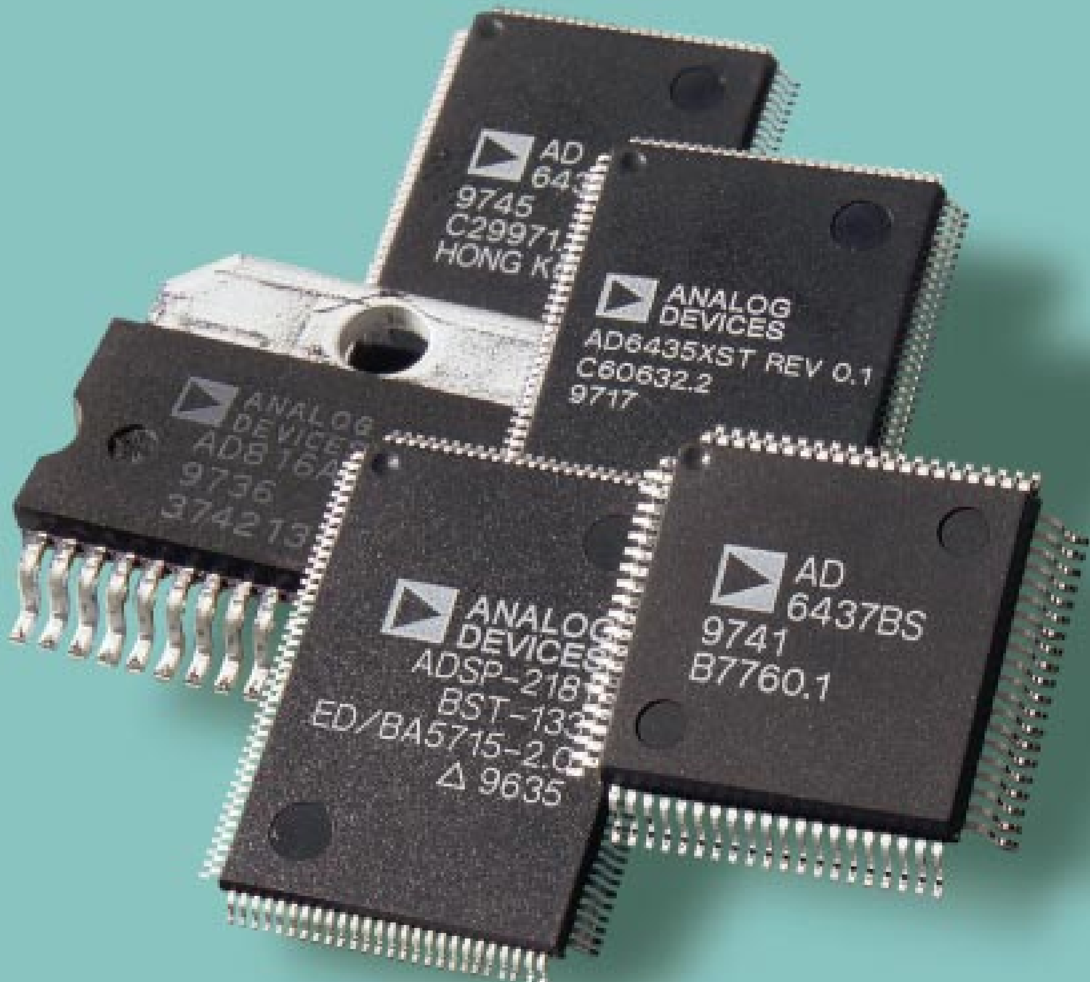
Consider, for example, the size and stature of the computer chip manufacturers who have already selected Aware's ADSL technology. In addition to collaborating with Analog Devices on multiple generations of ADSL chipsets, we also have a broad technology partnership with 3Com for DMT modems. Our relationship with Lucent Technologies is expected to produce the first PC modem chipset to support the requirements set forth by the Universal ADSL Working Group (UAWG) and the International Telecommunications Union (ITU).

Growing numbers of today's leading system vendors are also basing their ADSL product developments on Aware's technology. These include three of the four major digital loop carriers, three of the biggest networking and remote access vendors, six of the top telecommunications companies, and the two leading voiceband modem manufacturers.

What's more, Aware's new splitterless DMT technology is rapidly gaining momentum. Spearheaded by PC industry giants Compaq, Microsoft and Intel, the newly formed Universal ADSL Working Group (UAWG) is actively lobbying for the speedy establishment of splitterless DMT as an industry standard. In addition to PC, networking and semiconductor industry leaders, the UAWG includes key telecommunications service providers such as Ameritech, Bell Atlantic, BellSouth, GTE, MCI, SBC Communications, Sprint, US WEST, France Telecom, Deutsche Telekom and British Telecom — galvanizing the support of these pivotal members of the ADSL provider chain.

By gaining the consensus of the critical links in the ADSL provider chain, the UAWG's endorsement of splitterless DMT technology as an industry standard is expected to accelerate the final decision-making process of the official standard bodies and to release a groundswell of market demand for ADSL and splitterless DMT innovations. Currently positioned with an array of new DMT ADSL product solutions, Aware is well-prepared to capitalize on this demand.

AD20msp910 ADSL Chipset: Co-developed with Analog Devices, it's the lowest cost, most complete DMT ADSL solution.

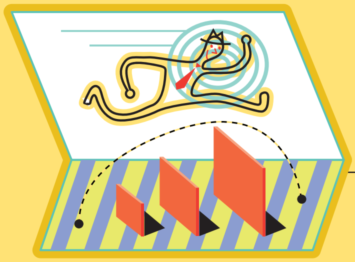


AD20msp910

ADSL Chipset

ADS–910

ADSL Development System



THE FUTURE SOLUTION

Beyond ADSL

Aware is constantly raising the bar for ultra high-speed data access as it takes its technological innovations to the next level. Our next generation technologies are already taking shape.

In the short term, we expect our new “lite” versions of our products which incorporate the full benefits of splitterless DMT technology to begin shipping soon. Chief among these is the x200 Lite, an easy-to-install external PC modem for customer premises that supports speeds of up to 1.5 Mbps downstream and 512 Kbps upstream. Our plans call for the x200 Lite to migrate into a lower-cost, mass-market device by year-end. In addition, our new AW-910 Lite transceiver module provides OEMs with an all-in-one solution for deploying splitterless DMT technology in central office equipment. Meanwhile, a new software upgrade, which enables our existing chipsets to interoperate with splitterless DMT central office and customer premise equipment, is expected to be available soon.

In addition, we are planning to further enhance our xDSL technology with our newly developed and patented line code, Discrete Wavelet Multitone (DWMT). Based on our pioneering wavelet technology, the new DWMT line code will add superior robustness and performance characteristics to our xDSL products by providing higher immunity to electrical noise and interference in the environment. A new chipset is currently in development which will incorporate this patented technology into our future xDSL products.

Looking farther ahead, the development of our DWMT technology opens up an even larger world of broadband network communications which extends beyond ADSL. For example, DWMT will be the backbone of new Very High Speed Digital Subscriber Line (VDSL) versions of our products, scheduled for next year. By further expanding the usable bandwidth of telephone lines for simultaneous data and voice communications, our DWMT technology will forge the future for high-speed copper access. In fact, it will be the engine for new products from Aware that target asymmetric data rates of up to 26 Mbps and symmetric data rates of up to 12 Mbps.

The future of high-speed data communications holds exciting possibilities. By continuing to push the technological envelope, Aware is developing ever-faster, ever-more-powerful solutions — effectively transforming those exciting possibilities into practical realities.

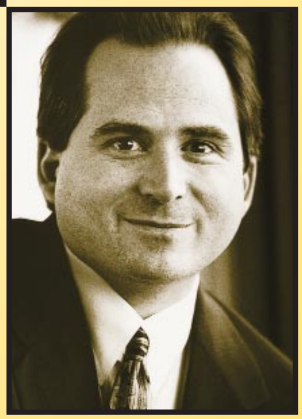
ADS-910 ADSL Development System: Complete test system for quickly integrating the AD20msp910 chipset into central office and customer premise equipment.

Senior Management

MICHAEL A. TZANNES
Chief Technology Officer
and General Manager
of Telecommunications

RICHARD P. MOBERG
Chief Financial Officer
and Treasurer

DAVID C. HUNTER
Senior Vice President,
Product Development



EDMUND C. REITER
Vice President,
Advanced Products

SELECTED FINANCIAL DATA

(in 000's, except per share data)	1997	1996	1995	1994	1993
	Year ended December 31,				
Statements of Operations Data					
Revenue	$ 6,198	$ 5,301	$ 3,260	$ 3,827	$ 3,172
Loss from operations	(6,157)	(538)	(454)	(1,095)	(1,028)
Net income (loss)	(4,448)	259	(343)	(1,012)	(992)
Net income (loss) per share – basic	($0.23)	$0.02	($0.29)	($0.88)	($0.87)
Net income (loss) per share — diluted	($0.23)	$0.01	($0.29)	($0.88)	($0.87)
Balance Sheet Data					
Cash and short-term investments	$26,104	$36,719	$ 2,154	$ 2,566	$ 186
Working capital	26,774	38,280	2,516	2,877	281
Total assets	39,281	40,123	3,228	3,930	978
Total liabilities	1,661	676	309	684	493
Total stockholders' equity	37,620	39,446	2,920	3,246	485

OVERVIEW

Aware, Inc. (the "Company") designs, develops and markets telecommunications software, hardware designs, chipsets and products that incorporate Asymmetric Digital Subscriber Line (ADSL), splitterless lite Digital Subscriber Line (DSL Lite), Very High Speed Digital Subscriber Line (VDSL), and Symmetric Digital Subscriber Line (SDSL) technologies. These broadband technologies are designed to increase the speed of data communications over conventional copper telephone lines. The Company's products are designed to allow telephone companies to utilize their installed bases of dedicated copper lines to provide both residential and business customers with interactive data transmission at speeds much higher than currently available. The Company also offers image compression software products.

RESULTS OF OPERATIONS

The following table sets forth, for the periods indicated, certain line items from the Company's consolidated statements of operations as a percentage of total revenue:

Year Ended December 31,	1997	1996	1995
Revenue:			
Product	15.7%	12.3%	12.5%
License and royalty	48.9	56.0	31.8
Research and development	35.4	31.7	55.7
Total revenue	100.0	100.0	100.0
Costs and expenses:			
Cost of product revenue	20.2	15.7	7.4
Research and development	110.9	61.0	71.6
Sales and marketing	36.9	14.5	12.6
General and administrative	31.4	18.9	22.3
Total costs and expenses	199.4	110.1	113.9
Loss from operations	(99.4)	(10.1)	(13.9)
Interest income	27.6	15.0	3.4
Net income (loss)	(71.8%)	4.9%	(10.5%)

Product Revenue

Product revenue in 1997 and 1996 consisted primarily of revenue from the sale of Asymmetric Digital Subscriber Line ("ADSL") modems, transceiver modules, and development systems. Product revenue increased by 49.9% from $649,000 in 1996 to $974,000 in 1997. Product revenue as a percentage of total revenue was 15.7% and 12.3% in 1997 and 1996, respectively. The product revenue increase in 1997 was primarily attributable to revenue from the sale of transceiver modules and development systems, which began shipping in the second quarter of 1997. Higher revenue from the sale of these new products was partially offset by modestly lower revenue from the sale of modems. The decline in revenue from the sale of modems in 1997 was primarily due to decreased demand for the Company's modems for ADSL technology trials while the market for ADSL products remained in an early stage of development.

Product revenue increased by 60% from $406,000 in 1995 to $649,000 in 1996. A year to year comparison of product revenue for these years is not meaningful due to differences in the composition of product revenue. Product revenue in 1996 consisted primarily of revenue from the sale of ADSL modems, which were introduced in early 1996. Product revenue in 1995 consisted primarily of revenue from the sale of video editing chipset products, which the Company discontinued in 1995.

License and Royalty Revenue

License and royalty revenue consisted primarily of revenue from the sale of intellectual property, such as hardware and software technology licenses, compression software licenses, and royalties from the sale of chipsets by customers who have licensed the Company's technology. As such revenue has only a nominal cost of sale associated with it, the Company does not report a separate cost of license and royalty revenue line in its Statements of Operations.

License and royalty revenue increased by 2% from $2,971,000 in 1996 to $3,031,000 in 1997. License and royalty revenue as a percentage of total revenue was 48.9% and 56.0% in 1997 and 1996, respectively. The dollar increase in license and royalty revenue in 1997 was primarily attributable to higher revenue from the sale of compression software licenses, which was partially offset by lower telecommunications license and royalty revenue. The increase in compression software license revenue was primarily due to a significant customer sale in the second quarter of 1997. The decrease in telecommunications license and royalty revenue was primarily attributable to a decline in revenue from royalty advances, which fell from $350,000 in 1996 to nothing in 1997. Approximately 63% of license and royalty revenue in 1997 was received from three customers.

License and royalty revenue increased by 187% from $1,037,000 in 1995 to $2,971,000 in 1996. The increase in 1996 was primarily attributable to an increase in the sale of ADSL and other broadband technology licenses to telephone company equipment suppliers. Revenue from the sale of compression software licenses also contributed to the increase in license and royalty revenue in 1996. Approximately 51% of license and royalty revenue in 1996 was received from three customers.

Research and Development Revenue

Research and development revenue consisted primarily of revenue from commercial contract engineering and development, and government research contracts. Research and development revenue as a percentage of total revenue was 35.4% and 31.7% in 1997 and 1996, respectively. Research and development revenue increased by 30.5% from $1,680,000 in 1996 to $2,193,000 in 1997. Higher research and development revenue in 1997 was primarily due to an increase in commercial engineering projects as well as a modest increase in U.S. government projects. The increase in commercial engineering projects is primarily driven by telecommunications customers, who have engaged the Company to assist them with the integration of the Company's technology into their products.

Research and development revenue decreased by 8% from $1,817,000 in 1995 to $1,680,000 in 1996. The decrease was primarily due to lower revenue from commercial research and development contracts as well as slightly lower revenue from U.S. government research contracts.

Cost of Product Revenue

Cost of product revenue consisted primarily of: (i) direct material, direct labor, and overhead costs to produce the Company's products, (ii) cost of goods for purchases of finished inventory from third party suppliers, and (iii) provisions for excess and obsolete inventory.

Cost of product revenue as a percentage of product revenue was 129% in 1997 as compared to 128% in 1996. The cost of product revenue as a percentage of product revenue in 1997 and 1996 primarily reflects high material, labor, and fixed manufacturing costs due to relatively low production volumes, and provisions for excess and obsolete inventory of $275,000 in 1997 and $365,000 in 1996. The provisions for obsolete inventory recorded in 1997 and 1996 were primarily driven by the environment in which the Company operates. This environment was and continues to be characterized by rapid technological advances, evolving industry standards, changes in end-user requirements, frequent new product introductions, and evolving telco offerings. Consequently, the Company's products have relatively short life cycles. Excluding obsolete inventory provisions, cost of product revenue as a percentage of product revenue was 100% in 1997 and 72% in 1996.

In the third quarter of 1997, the Company entered into an agreement with a third party contract manufacturer that will supply substantially all finished goods products to the Company. The Company anticipates that this arrangement will reduce per unit cost of sales if and when product volumes increase.

Cost of product revenue increased by 242% from $243,000 in 1995 to $831,000 in 1996. As a percentage of product revenue, cost of product revenue increased from 60% in 1995 to 128% in 1996. Such percentages primarily reflect the cost of modem revenue and obsolete inventory provisions in 1996 and the cost of video editing chipset revenue in 1995. Accordingly, a comparison of cost of product revenue on a year to year basis is not meaningful due to differences in the composition of product revenue.

Research and Development

Research and development expense consisted primarily of salaries for engineers, and expenses for consultants, recruiting, supplies, equipment, depreciation and facilities. Research and development expense increased by 113% from $3,235,000 in 1996 to $6,874,000 in 1997. The increase in research and development expense is primarily due to increased spending on projects related to the Company's x200 Access Router, DSL Lite technology, and SDSL technology. Spending related to these projects was partially offset by lower spending on the Company's Hybrid Fiber Coaxial (HFC) project, which was temporarily suspended in 1997. The Company anticipates that research and development spending will continue to grow in future periods.

Research and development expense increased by 39% from $2,333,000 in 1995 to $3,235,000 in 1996. The increase in research and development expense was primarily attributable to higher spending on projects to develop, enhance, and commercialize the Company's ADSL, VDSL, SDSL, and HFC broadband technologies. Higher spending on these projects was partially offset by lower spending as a result of the discontinuance of research involving audio compression technology and lower facilities costs as a result of the relocation of the Company's facilities in June 1995.

Selling and Marketing

Selling and marketing expense consisted primarily of salaries for sales and marketing personnel, travel, advertising and promotion, recruiting, and facilities expense. Selling and marketing expense increased 197% from $769,000 in 1996 to $2,286,000 in 1997. The increase was primarily due to: (i) the addition of sales staff to establish channels of distribution for the Company's products and technology, (ii) the addition of marketing staff, and (iii) increased levels of advertising and promotion to create awareness for the Company's products, including participation in major industry tradeshows. The Company anticipates that selling and marketing spending will continue to grow in future periods.

Selling and marketing expense increased 87% from $412,000 in 1995 to $769,000 in 1996. The increase was primarily due to the addition of sales personnel and increased product advertising related to the Company's ADSL modem.

General and Administrative

General and administrative expense consisted primarily of salaries for administrative personnel, facilities costs, expenses related to being a public company, and professional services, such as legal and audit expenses. General and administrative expense increased by 94% from $1,004,000 in 1996 to $1,943,000 in 1997. The increase was primarily due to: (i) additions to the Company's finance, information systems and administrative organizations to support organizational growth, and (ii) expenses related to investor relations and being a public company.

General and administrative expense increased by 38% from $726,000 in 1995 to $1,004,000 in 1996. The increase was primarily attributable to additions to the Company's management team and administrative infrastructure, and expenses associated with becoming a public company.

Interest Income

Interest income increased 114% from $798,000 in 1996 to $1,708,000 in 1997 primarily as a result of higher average cash balances due to the investment of net proceeds from the Company's initial public offering for the full year, as opposed to approximately five months in 1996. Interest income increased 621% from $111,000 in 1995 to $798,000 in 1996 primarily as a result of higher average cash balances due to the investment of net proceeds from the Company's initial public offering.

Provision for Income Taxes

The Company has made no provision for income taxes as it has a history of net losses, which has resulted in tax loss carryforwards. At December 31, 1997, the Company had available federal net operating loss carryforwards of approximately $16,586,000, which expire in 2003 through 2012, and federal research and development credit carryforwards of approximately $791,000, which expire in 2003 through 2012. At December 31, 1997, the Company also had available state net operating loss carryforwards of approximately $9,261,000, which expire in 1998 through 2002 and state research and development and investment tax credit carryforwards of approximately $395,000, which expire in 2006 through 2012. Of the total net operating loss carryforwards, approximately $1,906,000 was attributable to the exercise of stock options and the tax benefit from these losses, when utilized, will be credited to additional paid in capital.

Other Information

In 1997, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings per Share." Among other requirements, SFAS No. 128 requires restatement of prior period earnings per share to comply with the provisions of this pronouncement. Upon adoption of SFAS No. 128 in December 1997, the Company restated earnings per share by applying the provisions of the standard. As a result of this restatement, earnings per share for certain prior periods changed from the amounts previously reported.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 1997, the Company had cash, cash equivalents and short-term investments of $26,104,000, a decrease of $10,615,000 from the prior year. The Company has funded its operations primarily from sales of common stock, including an initial public offering in August 1996, which generated net proceeds of $35,200,000. In 1997, the Company used approximately $2,656,000 of cash to fund operating losses, which was essentially offset by $2,622,000 of proceeds from the issuance of common stock in connection with its stock option plans.

Accordingly, the decrease in cash, cash equivalents and short-term investments in 1997 was primarily due to purchases of property and equipment. Cash invested in property and equipment of $10,581,000 was primarily related to: (i) the purchase and renovation of a 72,000 square foot commercial office building for $8,224,000, and (ii) the acquisition of computers, software, furniture, and other equipment primarily used in research and development activities.

While there can be no assurance that the Company will not require additional financing, or that such financing will be available to the Company, the Company believes that its financial resources are adequate to meet its liquidity requirements over the next twelve months.

FACTORS THAT MAY AFFECT FUTURE RESULTS

Certain statements contained in this Annual Report, including statements regarding the anticipated development and expansion of the Company's business, the intent, belief or current expectations of the Company, its directors or its officers, primarily with respect to the future operating performance of the Company, and other statements contained herein regarding matters that are not historical facts, are "forward-looking" statements. These forward-looking statements represent the Company's present expectations or beliefs concerning future events, however the Company cautions that such statements are qualified by important factors. Such factors, which include, but are not limited to, the risk factors identified below, could cause actual results to differ materially from those indicated in this Annual Report.

The Company believes that the occurrence of any one or some combination of the following risk factors could have a material adverse effect on the Company's business, financial condition and results of operations.

History of Operating Losses

The Company has incurred operating losses in every fiscal year since inception. Substantial additional research and development expenses to enhance the performance and reduce the manufacturing costs of the Company's products will be required before market acceptance of these products can be determined. Also, the Company anticipates that substantial selling and marketing expenses will be required to establish sales channels for the Company's products and technology. There can be no assurance that the Company will achieve profitable operations in any future period.

Dependence on Acceptance of ADSL Technology

The Company's future success is substantially dependent upon whether ADSL technology gains widespread commercial acceptance by the telephone companies ("telcos") and end users of telco services. The Company has invested substantial resources in the development of ADSL technology implemented through the Discrete Multi-Tone ("DMT") modulation technique. Telcos continue to evaluate DMT-based ADSL technology, and there can be no assurance that the telcos will pursue the deployment of such ADSL technology. The Company believes that volume deployment of ADSL technology and equipment will not commence before the second half of 1998, if at all.

Reliance on Telcos; Dependence on a Limited Number of Customers

Even if telcos adopt policies favoring full-scale implementation of ADSL technology, there can be no assurance that sales of the Company's ADSL products will become significant. The Company's customers, including Regional Bell Operating Companies ("RBOCs"), OEMs and other telcos, are relatively few in number and have significantly greater resources than that of the Company. The Company has limited ability to influence or control decisions made by these customers. There can be no assurance that these customers will not use their size and bargaining power to demand unfavorable terms and conditions (including price), seek alternative suppliers, or undertake internal development of products comparable to those of the Company's.

Substantial Dependence on Analog Devices, Inc.

The Company and Analog Devices, Inc. ("ADI") have entered into a series of agreements to develop integrated chipsets based on the Company's technology. The inability or refusal of ADI to manufacture, market and sell such chipsets in substantial quantities would prevent telcos from adopting the Company's technology and would have a material adverse effect on the Company's business. There can be no assurance that the Company's relationship with ADI will be successful or, in the event that the relationship is not successful, that the Company would be able to find a substitute chipset manufacturer without significant delays.

Proprietary Technology; Risk of Third Party Claims of Infringement

The Company's ability to compete effectively will depend to a significant extent on its ability to protect its proprietary information and to operate without infringing the intellectual property rights of others. Despite the precautions the Company has taken to protect its intellectual property, there can be no assurance that such steps will be adequate to prevent the misappropriation of its technology. In addition, third parties may assert exclusive patent, copyright and other intellectual property rights to technologies that are important to the Company. There can be no assurance that other third parties will not assert such claims against the Company in the future.

Rapid Technological Change; Dependence on New Products

The markets for the Company's products are characterized by rapid technological advances, evolving industry standards, changes in end-user requirements, frequent new product introductions, and evolving telco offerings. The Company's business will be materially adversely affected if technologies or standards on which Company's products are based become obsolete, or if the Company is unable to develop and introduce new products in a timely manner in response to changing market conditions. In such an environment, product cycles tend to be short, and therefore, the Company may need to write-off excess and obsolete inventory from time-to-time. The Company recorded provisions for excess and obsolete inventory of $275,000 and $365,000 in 1997 and 1996, respectively.

Competition

The markets for the Company's products are intensely competitive and the Company expects competition to increase in the immediate future. Many of the Company's competitors and potential competitors have significantly greater financial, technological, manufacturing, marketing and personnel resources than the Company. There can be no assurance that the Company will be able to compete successfully or that competition will not adversely affect the Company's business.

Manufacturing

The Company has limited experience in manufacturing or in supervising the manufacture of its products, including its ADSL modems, modules, and development systems. In 1997, the Company entered into an agreement with a third party contract manufacturer that will supply substantially all finished goods products to the Company. There can be no assurance that the Company's relationship with its contract manufacturer will be successful or, in the event that the relationship is not successful, that the Company would be able to find a substitute contract manufacturer without significant delays. Furthermore, there can be no assurance that the Company or its contract manufacturer will not encounter significant difficulties in manufacturing or controlling the quality of its products, or that its products will be reliable in the field.

Dependence on Hiring and Retaining Personnel

The Company believes that its future success will depend significantly on its ability to attract, motivate and retain additional highly skilled technical, managerial and marketing personnel. During 1997, the Company experienced difficulty in hiring the additional engineers it had contemplated in its business plans. Competition for such personnel is intense, and there can be no assurance that the Company will be successful in attracting, assimilating and retaining the personnel required to grow and operate profitably.

Year 2000

The Company is in the process of assessing the impact of the transition to the year 2000 on its computer and software applications. The Company does not believe that any material year 2000 issues exist with software contained within its product offerings. The Company is in the process of attempting to obtain confirmation from vendors of certain purchased software that current releases or upgrades, if installed, will not have any material year 2000 issues. To the extent necessary to address material year 2000 issues, the Company plans to obtain current releases or upgrades from software vendors prior to the end of 1998. Failure to obtain and implement such releases or upgrades, or the failure of such software vendors to have eliminated year 2000 issues, could materially and adversely affect the Company.

December 31,	1997	1996
ASSETS		
Current assets:		
Cash and cash equivalents	$ 23,496,508	$ 31,092,273
Short-term investments	2,607,411	5,626,725
Accounts receivable (less allowance for doubtful accounts of $50,000 in 1997 and $35,000 in 1996)	1,824,119	1,654,980
Unbilled accounts receivable	—	110,722
Inventories	215,622	447,534
Prepaid expenses	290,847	23,426
Total current assets	28,434,507	38,955,660
Property and equipment, net of accumulated depreciation and amortization of $1,330,281 in 1997 and $557,901 in 1996	10,846,025	1,166,928
Total assets	$ 39,280,532	$ 40,122,588
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 1,075,126	$ 337,339
Accrued expenses	185,676	60,091
Accrued compensation	326,558	173,692
Accrued professional	73,370	65,000
Deferred revenue	—	40,000
Total current liabilities	1,660,730	676,122
Commitments and contingent liabilities		
Stockholders' equity:		
Preferred stock, $1.00 par value; 1,000,000 shares authorized, none outstanding	—	—
Common stock, $.01 par value; 30,000,000 shares authorized; issued and outstanding, 19,646,024 in 1997 and 18,959,897 in 1996	196,460	189,600
Additional paid-in capital	52,640,360	50,025,548
Accumulated deficit	(14,764,056)	(10,315,720)
Treasury stock	(452,962)	(452,962)
Total stockholders' equity	37,619,802	39,446,466
Total liabilities and stockholders' equity	$ 39,280,532	$ 40,122,588

The accompanying notes are an integral part of the financial statements.

Year Ended December 31,	1997	1996	1995
Revenue:			
Product	$ 973,782	$ 649,422	$ 406,459
License and royalty	3,031,483	2,971,238	1,036,615
Research and development	2,192,786	1,680,449	1,816,820
Total revenue	6,198,051	5,301,109	3,259,894
Costs and expenses:			
Cost of product revenue	1,251,677	831,241	242,983
Research and development	6,874,137	3,234,799	2,333,200
Selling and marketing	2,285,726	769,395	411,777
General and administrative	1,943,187	1,003,948	725,511
Total costs and expenses	12,354,727	5,839,383	3,713,471
Loss from operations	(6,156,676)	(538,274)	(453,577)
Interest income	1,708,340	797,656	110,615
Net income (loss) before provision for income taxes	(4,448,336)	259,382	(342,962)
Provision for income taxes	—	—	—
Net income (loss)	($ 4,448,336)	$ 259,382	($ 342,962)
Net income (loss) per share — basic	($0.23)	$0.02	($0.29)
Net income (loss) per share — diluted	($0.23)	$0.01	($0.29)
Weighted average shares — basic	19,328,252	10,841,919	1,162,717
Weighted average shares — diluted	19,328,252	17,991,446	1,162,717

The accompanying notes are an integral part of the financial statements.

Year Ended December 31,	1997	1996	1995
Cash flows from operating activities:			
Net income (loss)	($ 4,448,336)	$ 259,382	($ 342,962)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	901,976	352,715	200,701
Increase (decrease) from changes in assets and liabilities:			
Accounts receivable	(169,139)	(1,154,152)	94,168
Unbilled accounts receivable	110,722	5,539	187,840
Inventories	231,912	(407,821)	(18,044)
Prepaid expenses	(267,421)	(8,955)	59,071
Accounts payable	737,787	225,820	14,757
Accrued expenses	286,821	151,492	(350,150)
Deferred revenue	(40,000)	(10,000)	(39,720)
Net cash used in operating activities	(2,655,678)	(585,980)	(194,339)
Cash flows from investing activities:			
Purchases of property and equipment	(10,581,073)	(1,116,238)	(234,131)
Net sales (purchases) of short-term investments	3,019,314	(5,626,725)	—
Net cash used in investing activities	(7,561,759)	(6,742,963)	(234,131)
Cash flows from financing activities:			
Proceeds from issuance of common stock, net of issuance costs	2,621,672	36,267,535	16,023
Net cash provided by financing activities	2,621,672	36,267,535	16,023
Increase (decrease) in cash and cash equivalents	(7,595,765)	28,938,592	(412,447)
Cash and cash equivalents, beginning of period	31,092,273	2,153,681	2,566,128
Cash and cash equivalents, end of period	$ 23,496,508	$31,092,273	$2,153,681

Supplemental Noncash Disclosures:			
Conversion of preferred stock to common stock	—	$ 127,998	—
Repurchase of Series D preferred shares for cancellation of notes	—	—	$ 457,062

The accompanying notes are an integral part of the financial statements.

	Convertible Preferred Stock			
	Series B	Series C	Series D	Series E
Balance, December 31, 1994	$ 15,875	$ 13,525	$ 73,266	$ 29,432
Exercise of common stock options, 16,867 shares	—	—	—	—
Repurchase of Series D preferred stock, 4,100 shares	—	—	(4,100)	—
Net loss	—	—	—	—
Balance, December 31, 1995	15,875	13,525	69,166	29,432
Issuance of common stock in initial public offering, net of issuance costs, 3,910,000 shares	—	—	—	—
Exercise of common stock options, 1,083,162 shares	—	—	—	—
Conversion of preferred stock to common stock, 12,799,800 shares	(15,875)	(13,525)	(69,166)	(29,432)
Net income	—	—	—	—
Balance, December 31, 1996	—	—	—	—
Exercise of common stock options, 686,127 shares	—	—	—	—
Net loss	—	—	—	—
Balance, December 31, 1997	$ —	$ —	$ —	$ —

The accompanying notes are an integral part of the financial statements.

Common Stock	Additional Paid-In Capital	Accumulated Deficit	Notes Receivable For Issued Stock	Treasury Stock	Total Stockholders' Equity
$ 11,501	$13,792,091	($10,232,140)	($457,062)	$ —	$ 3,246,488
169	15,854	—	—	—	16,023
—	—	—	457,062	(452,962)	—
—	—	(342,962)	—	—	(342,962)
11,670	13,807,945	(10,575,102)	—	(452,962)	2,919,549
39,100	35,123,900	—	—	—	35,163,000
10,832	1,093,703	—	—	—	1,104,535
127,998	—	—	—	—	—
—	—	259,382	—	—	259,382
189,600	50,025,548	(10,315,720)	—	(452,962)	39,446,466
6,860	2,614,812	—	—	—	2,621,672
—	—	(4,448,336)	—	—	(4,448,336)
$196,460	$52,640,360	($14,764,056)	$ —	($452,962)	$37,619,802

1. NATURE OF BUSINESS

Aware, Inc. (the "Company") designs, develops and markets telecommunications software, hardware designs, chipsets and products that incorporate Asymmetric Digital Subscriber Line (ADSL), splitterless lite Digital Subscriber Line (DSL Lite), Very High Speed Digital Subscriber Line (VDSL), and Symmetric Digital Subscriber Line (SDSL) technologies. These broadband technologies are designed to increase the speed of data communications over conventional copper telephone lines. The Company's products are designed to allow telephone companies to utilize their installed bases of dedicated copper lines to provide both residential and business customers with interactive data transmission at speeds much higher than currently available. The Company also offers image compression software products.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation. The consolidated financial statements include the accounts of Aware, Inc. and its subsidiary. All significant intercompany transactions have been eliminated.

Cash and Cash Equivalents. Cash and cash equivalents consist primarily of demand deposits, money market funds, commercial paper, and discount notes in highly liquid short-term instruments with original maturities of three months or less from the date of purchase and are stated at cost, which approximates market.

Short-term Investments. The Company follows Statement of Financial Accounting Standards ("SFAS") No. 115, "Accounting for Certain Investments in Debt and Equity Securities. At December 31, 1997, the Company had categorized all securities as "available-for-sale," since the Company may liquidate these investments currently. At December 31, 1996, the Company had categorized all investments with maturities of less than one year as "held-to-maturity", because of the Company's intent and ability to hold such securities to maturity. In calculating realized gains and losses, cost is determined using specific identification. Held-to-maturity securities are carried at amortized cost. SFAS No. 115 requires that unrealized gains and losses on available-for-sale securities be excluded from earnings and reported in a separate component of stockholders' equity. As of December 31, 1997 and 1996, unrealized gains and losses were not material.

The amortized cost of securities, which approximates fair value, consists of the following at December 31, 1997 and 1996:

	Maturity		
Type of security	Less than one year	One to five years	Total
1997:			
Corporate debt securities	$1,574,474	—	$1,574,474
U.S. agency securities	1,032,937	—	1,032,937
Total	$2,607,411	—	$2,607,411
1996:			
Corporate debt securities	$3,040,072	$1,602,023	$4,642,095
U.S. agency securities	984,630	—	984,630
Total	$4,024,702	$1,602,023	$5,626,725

Allowance for Doubtful Accounts. Accounts are charged to the allowance for doubtful accounts as they are deemed uncollectible based on a periodic review of the accounts. Bad debt expense was approximately $26,000, $20,000, and $5,000 for 1997, 1996, and 1995, respectively.

Inventories. Inventories are stated at the lower of cost or market with cost being determined by the first-in, first-out ("FIFO") method.

Property and Equipment. Property and equipment are stated at cost. Depreciation and amortization of property and equipment is provided using the straight-line method over the estimated useful lives of the assets ranging from three to thirty years.

The Company accounts for the impairment of long-lived assets in accordance with the provisions of SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of."

Revenue Recognition. Product revenue consists primarily of revenue from the sale of tangible products, such as modems, transceiver modules, development systems and compression chipsets. Revenue is recognized upon shipment.

License and royalty revenue consists primarily of revenue from the sale of intellectual property, such as hardware and software technology licenses, compression software licenses, and royalties from the sale of chipsets by customers who have licensed the Company's technology. Revenue from the sale of technology licenses for the initial transfer of hardware and software designs is recognized when a definitive agreement is reached, the transfer has been effected, and no contingent factors are present. Revenue from the sale of compression software licenses is recognized upon shipment. Royalty revenue is recognized based upon sales reports from customers.

Research and development revenue is comprised of revenue from government and commercial research and development contracts. Revenue on government contracts is generally recognized when services are performed. Revenue on commercial contracts is generally recognized as research is performed and milestones are achieved under the terms of the respective agreements.

Unbilled accounts receivable are stated at estimated realizable value. These amounts will be billable to customers based on the terms of contracts which include achievement of milestones or completion of the contract.

Income Taxes. The Company accounts for income taxes under SFAS No. 109, "Accounting for Income Taxes." SFAS No. 109 requires the Company to compute deferred income taxes based on the differences between the financial statement and tax basis of assets and liabilities using enacted rates in effect in the years in which the differences are expected to reverse. SFAS No. 109 also requires the Company to establish valuation allowances to offset temporary deductible differences, net operating loss carryforwards and tax credits, which are not likely to be realized.

Capitalization of Software Costs. The Company capitalizes certain internally generated software development costs after technological feasibility of the product has been established. Capitalized software costs also include amounts paid for purchased software, which has reached technological feasibility. Such costs are amortized, on a product-by-product basis, on a straight-line basis over their useful economic lives (generally two to four years), or the ratio of current gross revenues to total gross current and future revenues, whichever is greater. There were no capitalized software costs at December 31, 1997 and 1996, because such costs incurred subsequent to the establishment of technological feasibility, but prior to commercial availability, were immaterial.

Concentration of Risk. At December 31, 1997 and 1996, the Company had bank cash balances and money market investments, in excess of federally insured deposit limits of approximately $26,004,000 and $36,619,000, respectively.

Concentration of credit risk with respect to accounts receivable is limited to $524,000, $400,000, and $154,000 with three customers at December 31, 1997 and to $549,000, $275,000 and $155,000 with three customers at December 31, 1996.

In 1997, the Company entered into an agreement with a third party contract manufacturer that will supply substantially all finished goods products to the Company.

Stock-Based Compensation. The Company grants stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. As permitted by SFAS No. 123, the Company accounts for stock option grants in accordance with Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees." Accordingly, the Company recognized no compensation expense for stock option grants.

Net Income (Loss) Per Share. In 1997, the Company adopted SFAS No. 128, "Earnings Per Share." SFAS No. 128 establishes standards for computing and presenting earnings per share and applies to entities with publicly held common stock or potential common stock. Prior to 1997, the Company computed earnings per share in accordance with APB Opinion No. 15, "Earnings per Share." As a result of implementation of SFAS No. 128, net income (loss) per share for the years ended December 31, 1996 and 1995 has been restated.

Use of Estimates. The preparation of the Company's financial statements in conformity with generally accepted accounting principles necessarily requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and to disclose contingent assets and liabilities at the balance sheet date. Significant estimates include reserves for doubtful accounts, reserves for excess and obsolete inventory, useful lives of fixed assets, valuation allowance for deferred income tax assets, and accrued liabilities. Actual results may differ from these estimates.

Fair Value of Financial Instruments. The carrying amounts of cash and cash equivalents, short-term investments, accounts receivable, accounts payable and accrued expenses approximate fair value because of their short-term nature.

Future Adoption of Accounting Pronouncements. In 1997, the Financial Accounting Standards Board issued SFAS No. 130, "Reporting Comprehensive Income", and SFAS No. 131, "Disclosure About Segments of an Enterprise and Related Information."

SFAS No. 130 requires that all items that are required to be recognized under accounting standards as components of comprehensive income (revenues, expenses, gains and losses) be reported in a financial statement that is displayed with the same prominence as other financial statements. The provisions of SFAS No. 130 are effective for fiscal years beginning after December 15, 1997. The Company believes that changes made to comply with this statement will not have a material effect on the Company's consolidated financial position or results of operations.

SFAS No. 131 requires public business enterprises to report financial and descriptive information about its operating segments. The provisions of SFAS No. 131 are effective for periods beginning after December 15, 1997. The Company believes that implementation of this statement will not have a material effect on the Company's consolidated financial position or results of operations, but may impact the level of disclosure of its segment information.

In October 1997, the American Institute of Certified Public Accountants issued Statement of Position (SOP) No. 97-2, "Software Revenue Recognition." SOP No. 97-2 provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. The provisions of SOP No. 97-2 are effective for periods beginning after December 15, 1997. The Company believes that implementation of this statement will not have a material effect on the Company's consolidated financial position or results of operations.

3. INVENTORIES

Inventories consisted of the following at December 31:

	1997	1996
Raw materials	$163,555	$408,643
Work-in-process	—	38,891
Finished goods	52,067	—
Total	$215,622	$447,534

4. PROPERTY AND EQUIPMENT

Property and equipment consisted of the following at December 31:

	1997	1996
Land	$ 1,080,000	$ —
Building	7,144,656	—
Computer equipment	1,996,164	983,819
Furniture and fixtures	401,979	124,677
Office equipment	142,313	83,917
Manufacturing equipment	262,610	118,998
Purchased software	1,148,584	375,467
Leasehold improvements	—	37,951
Total	12,176,306	1,724,829
Less accumulated depreciation and amortization	(1,330,281)	(557,901)
Net	$10,846,025	$1,166,928

5. INCOME TAXES

Deferred income tax assets at December 31 are attributable to the following:

	1997	1996
Federal net operating loss carryforwards	$ 5,641,000	$ 3,367,000
Research and development and other tax credit carryforwards	1,526,000	761,000
State net operating loss carryforwards	880,000	518,000
Depreciation	41,000	69,000
Accrued expenses	88,000	187,000
Prepaid expenses	(94,000)	—
Deferred revenue	—	22,000
Alternative minimum tax credit	—	6,000
Total	8,082,000	4,930,000
Less valuation allowance	(8,082,000)	(4,930,000)
Net	$ —	$ —

A valuation allowance is provided against temporary deductible differences, net operating loss carryforwards and tax credits, which are not likely to be realized. During 1997 and 1996, the net valuation allowance was increased to fully reserve gross deferred tax assets.

A reconciliation of the U.S. federal statutory rate to the effective tax rate is as follows:

	1997	1996	1995
Federal statutory rate	(34)%	34%	(34)%
State rate, net of federal benefit	(6)	6	(6)
Tax credits	(17)	(69)	(10)
Operating losses and tax credits with no current tax benefit	57	69	50
Tax benefit from the utilization of net operating loss carryforwards	—	(40)	—
Effective tax rate	—%	—%	—%

The Company has made no provision for income taxes as it has a history of net losses, which has resulted in tax loss carryforwards. At December 31, 1997, the Company had available federal net operating loss carryforwards of approximately $16,586,000, which expire in 2003 through 2012, and federal research and development credit carryforwards of approximately $791,000, which expire in 2003 through 2012. At December 31, 1997, the Company also had available state net operating loss carryforwards of approximately $9,261,000, which expire in 1998 through 2002 and state research and development and investment tax credit carryforwards of approximately $395,000, which expire in 2006 through 2012. Of the total net operating loss carryforwards, approximately $1,906,000 are attributable to the exercise of stock options and the tax benefit from these losses, when utilized, will be credited to additional paid-in capital.

6. STOCKHOLDERS' EQUITY

Common Stock. In 1996, the Company increased the number of shares of authorized common stock from 18,650,000 to 30,000,000.

In August 1996, the Company completed an initial public offering of its common stock consisting of 3,910,000 shares at $10.00 per share. Proceeds to the Company, net of issuance costs, were approximately $35,163,000 (issuance costs were approximately $3,937,000).

In accordance with the terms of the underlying agreements, all outstanding shares of Series B, C, D, and E convertible preferred stock were automatically converted into common stock upon completion of the initial public offering.

Preferred Stock. In 1996, the Company authorized 1,000,000 shares of $1.00 par value preferred stock.

7. STOCK COMPENSATION PLANS

At December 31, 1997, the Company has three stock-based compensation plans, which are described below. The Company adopted SFAS No. 123, but, as permitted, applies APB Opinion No. 25 and related Interpretations in accounting for its plans. Accordingly, no compensation cost has been recognized for its fixed stock option plans and its employee stock purchase plan. The Company has no performance-based stock option plans. Had compensation cost for the Company's three stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, the Company's net income (loss) and per share amounts would have been adjusted to the pro forma amounts indicated below:

Year ended December 31,	1997	1996	1995
Net income (loss)			
As reported	($4,448,336)	$ 259,382	($342,962)
Pro forma	($8,531,745)	($4,403,824)	($580,611)
Basic earnings (loss) per share			
As reported	($0.23)	$0.02	($0.29)
Pro forma	($0.44)	($0.41)	($0.50)
Diluted earnings (loss) per share			
As reported	($0.23)	$0.01	($0.29)
Pro forma	($0.44)	($0.24)	($0.50)

The fair value of options on their grant date was measured using the Black-Scholes option pricing model. Key assumptions used to apply this pricing model are as follows:

Year ended December 31,	1997	1996	1995
Average risk-free interest rate	6.48%	6.25%	6.25%
Expected life of option grants	5 years	4 years	4 years
Expected volatility of underlying stock	96%	97%	97%
Expected dividend yield	—	—	—

Fixed Stock Option Plans. The Company has two fixed option plans. Under the 1990 Incentive and Nonstatutory Stock Option Plan, the Company may grant incentive stock options or nonqualified stock options to its employees and directors for up to 2,873,002 shares of common stock. Under the 1996 Stock Option Plan, the Company may grant incentive stock options or nonqualified stock options to its employees and directors for up to 3,000,000 shares of common stock. Under both plans, options: are granted at an exercise price as determined by the Board of Directors; have a maximum term of ten years; and generally vest either: (i) on a monthly basis over three years, or (ii) 40% two years from the date of grant with the remaining 60% vesting on a monthly basis over the next three years.

A summary of the status of the Company's two fixed stock option plans as of December 31, 1997, 1996, and 1995, and changes during the years ending on those dates is presented below:

	1997		1996		1995	
	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price	Shares	Weighted Avg. Exercise Price
Outstanding at beginning of year	3,396,408	$ 5.01	2,757,500	$ 1.21	2,481,948	$1.45
Granted	913,186	12.20	1,818,250	9.10	1,139,750	1.30
Exercised	686,127	3.82	1,083,162	1.02	16,867	.95
Forfeited	69,296	9.10	96,180	14.54	847,331	1.90
Outstanding at end of year	3,554,171	$ 7.01	3,396,408	$ 5.01	2,757,500	$1.21
Options exercisable at year end	1,754,552		1,343,617		1,447,474	
Weighted-average grant date fair value of options granted during the year	$9.28		$6.07		$0.92	

The following table summarizes information about stock options outstanding at December 31, 1997:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number Outstanding at 12/31/97	Weighted Avg. Remaining Contractual Life	Weighted Avg. Exercise Price	Number Exercisable at 12/31/97	Weighted Avg. Exercise Price
$1 to 2	1,222,329	7.1 years	$ 1.30	1,046,230	$ 1.31
8 to 9	1,178,406	8.4	8.25	613,075	8.25
10 to 11	450,000	9.2	10.29	87,387	10.31
12 to 13	703,436	9.4	12.75	7,860	12.75
	3,554,171	8.3	$ 7.01	1,754,552	$ .23

Employee Stock Purchase Plan. In June 1996, the Company adopted an Employee Stock Purchase Plan (the "ESPP Plan") under which eligible employees may purchase common stock at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or end of each six-month offering period. Participation in the ESPP Plan is limited to 6% of an employee's compensation, may be terminated at any time by the employee and automatically ends on termination of employment with the Company. A total of 100,000 shares of common stock have been reserved for issuance. During 1997 and 1996, no shares of common stock were issued under this plan, as the Company had not commenced implementation of the plan.

8. COMMITMENTS AND CONTINGENT LIABILITIES

Lease Commitments. In 1995, the Company entered into a three-year noncancelable operating lease for its principal office and research facilities commencing June 1, 1995. In November 1996, the Company entered into a twelve-month operating lease for additional space for its research facilities commencing December 1, 1996. In November 1997, both of these leases were either terminated or allowed to lapse at no cost to the Company, and the Company moved into a new building that it had purchased.

At December 31, 1997, the Company has no material operating leases.

Rental expense was approximately $308,000, $143,000, and $283,000 in 1997, 1996 and 1995, respectively.

Litigation. There are no material pending legal proceedings to which the Company is a party or to which any of its properties are subject which, either individually or in the aggregate, are expected by the Company to have a material adverse effect on its business, financial position or results of operations.

9. TRANSACTIONS WITH RELATED PARTIES

Consulting Agreements. In prior years, the Company had paid consulting fees for scientific research and development services provided by certain stockholders. The total charges from related parties approximated $8,000, and $66,000 in 1996 and 1995. There were no amounts due to related parties at December 31, 1997 and 1996.

10. MAJOR CUSTOMERS

The portion of total revenue that was derived from major customers was as follows:

Year ended December 31,	1997	1996	1995
Customer A	16%	—	—
Customer B	13%	12%	12%
Customer C	12%	17%	23%
Customer D	7%	22%	—
Customer E	—	10%	—
Customer F	—	—	18%
Customer G	—	—	10%

11. EMPLOYEE BENEFIT PLAN

In 1994, the Company established a qualified 401(k) Retirement Plan (the "Plan") under which employees are allowed to contribute certain percentages of their pay, up to the maximum allowed under Section 401(k) of the Internal Revenue Code. Company contributions to the Plan are at the discretion of the Board of Directors. There were no Company contributions in 1997, 1996 and 1995.

12. NET INCOME (LOSS) PER SHARE

A reconciliation of weighted average shares used for the basic computation and that used for the diluted computation is as follows:

Year ended December 31,	1997	1996	1995
Weighted average shares — basic	19,328,252	10,841,919	1,162,717
Dilutive effect of:			
Convertible preferred stock	—	5,467,106	—
Options	—	1,682,421	—
Weighted average shares — diluted	19,328,252	17,991,446	1,162,717

For the years ended December 31, 1997 and 1995, potential common shares are not included in the per share calculations for diluted EPS, because the effect of their inclusion would be antidilutive. For the year ended December 31, 1996, options to purchase 1,737,750 shares of common stock at an average weighted price of $8.57 per share were outstanding, but were not included in the computation of diluted EPS because the options' exercise prices were greater than the average market price of the common shares.

13. QUARTERLY RESULTS OF OPERATIONS — UNAUDITED

The following table presents unaudited quarterly operating results for each of the Company's eight quarters in the two-year period ended December 31, 1997:

	1997			
Quarters ended	March 31	June 30	Sept. 30	Dec. 31
Revenue	$1,801,085	$1,870,417	$ 722,500	$ 1,804,049
Loss from operations	(724,586)	(748,143)	(2,569,699)	(2,114,248)
Net loss	(276,302)	(275,398)	(2,145,946)	(1,750,690)
Net loss per share – Basic	($0.01)	($0.01)	($0.11)	($0.09)
Net loss per share – Diluted	($0.01)	($0.01)	($0.11)	($0.09)

	1996			
Quarters ended	March 31	June 30	Sept. 30	Dec. 31
Revenue	$ 962,003	$1,128,475	$ 1,505,820	$ 1,704,811
Income (loss) from operations	17,651	18,300	4,250	(578,475)
Net income (loss)	41,151	48,668	261,683	(92,120)
Net income (loss) per share – Basic	$0.04	$0.01	$0.02	$0.00
Net income (loss) per share – Diluted	$0.00	$0.00	$0.01	$0.00

THE BOARD OF DIRECTORS AND STOCKHOLDERS OF AWARE, INC.

We have audited the accompanying consolidated balance sheets of Aware, Inc. (the "Company") as of December 31, 1997 and 1996, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 1997. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Aware, Inc. at December 31, 1997 and 1996, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 1997, in conformity with generally accepted accounting principles.

Deloitte + Touche LLP

Deloitte & Touche LLP

Boston, Massachusetts
January 27, 1998

BOARD OF DIRECTORS

Charles K. Stewart
Chairman of the Board
Aware, Inc.

James C. Bender
President and Chief Executive Officer
Aware, Inc.

David Ehreth
Division Vice President
DSC Communications, Inc.

Jerald G. Fishman
President, Chief Executive Officer, Director
Analog Devices, Inc.

John K. Kerr
General Partner
Grove Investment Partners

John S. Stafford
Member
Chicago Board of Options

Michael A. Tzannes
Chief Technology Officer and
General Manager of Telecommunications
Aware, Inc.

OFFICERS

James C. Bender
President and Chief Executive Officer

Michael A. Tzannes
Chief Technology Officer and General Manager
of Telecommunications

David C. Hunter
Senior Vice President, Product Development

Richard P. Moberg
Chief Financial Officer and Treasurer

Edmund C. Reiter
Vice President, Advanced Products

LEGAL COUNSEL

Foley, Hoag & Eliot LLP, Boston, MA

INDEPENDENT ACCOUNTANTS

Deloitte & Touche LLP, Boston, MA

TRANSFER AGENT

Boston Equiserve
150 Royall Street
Canton, MA 02021

ANNUAL MEETING

The annual meeting will be held at 9:00 a.m. on Wednesday, May 27, 1998 at the Bedford Renaissance Hotel in Bedford, MA.

STOCK LISTING

The Company's common stock is traded on the Nasdaq National Market under the symbol AWRE.

STOCK PRICE HISTORY BY QUARTER

1997	First	Second	Third	Fourth
High	14 7/8	16 7/8	15 1/8	14 15/16
Low	8 5/8	8 1/2	9 5/8	9 1/8

1996	First	Second	Third	Fourth
High	n/a	n/a	19	17 1/2
Low	n/a	n/a	10 1/2	8 1/2

The preceding table sets forth the high and low sales prices as reported on the Nasdaq National Market from August 9, 1996, the date of the Company's initial public offering, to December 31, 1997. As of February 17, 1998, the Company had approximately 131 shareholders of record. This number does not include shareholders for whom shares were held in a "nominee" or "street name." The Company has never paid cash dividends on its common stock and anticipates it will continue to reinvest any earnings to finance future operations.

CORPORATE HEADQUARTERS

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http://www.aware.com

INVESTOR RELATIONS

For a copy of the Company's Form 10-K, copies of this report or other financial information, contact:

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